

The case for independent scholarship in auditing as human capital

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Thanks for the opportunity to speak with you today. I congratulate the Committee for identifying many important structural and practical problems facing the public company auditing profession that affect the public interest.

Human capital is at the core of any profession and independent professional scholarship is an essential element of human capital. Today I'll comment on the decline of independent audit scholarship that, I believe, underlies three of your recommendations.

Professional education (knowledge transfer) and research (knowledge creation) typically involve study of current and alternative professional practices. For example, it is difficult to imagine becoming a surgeon without learning how practicing surgeons typically approach a particular surgical procedure. Current surgical practices are analyzed and tested against promising alternatives by university-based researchers – researchers who are not paid by practicing surgeons or by their regulators. Finally, to protect the public interest, courts and legislatures use knowledge about the best surgical practices to evaluate and regulate surgeons' individual and collective performance.

For several decades prior to about 1990, the same knowledge creation and transfer process described the public company auditing profession. Large audit firms shared audit practices with professors through audit manuals, journal articles, training sessions, and audit methods conferences. They provided access to data such as audit adjustments, fees, and audit labor hours, as well as access to personnel for participation in research studies.

Professors used the knowledge gained to improve classroom instruction and to conduct research about the effectiveness and efficiency of alternative auditing practices. In turn, professors brought to auditing practice insights and solutions to practice problems using broad knowledge borrowed and adapted from psychology, economics, political science, governance, statistics, game theory, and computer science.

Practitioner/professor contact declined after about 1990. Some observers believe the decline was due to audit firms' increasing concerns about litigation. Others attribute it to cost and competitive disadvantage, while some say it reflected de-emphasis of auditing in the mid-1990s. Whatever the cause, the decline accelerated after SOX and formation of the PCAOB. The PCAOB has not been a substantial vehicle for systematic knowledge transfer and, to my knowledge, it does not employ audit-trained researchers.

Today, we know a great deal from archival research on the *output* of auditing practice (that is, research *about* auditing). We know how stock prices are related to financial information, to *restatements* of financial information and whether management judgment

or fraud is present, and whether analysts' forecasts are met. In fact, in leading scholarly accounting journals today, more studies are published about analysts' earnings forecast behaviors than about how auditors determine audited earnings!

As to costs and benefits of public company audits, we know that audit fees of 2,590 accelerated filers audited by Big Four auditors from 2003 through 2006 increased by 93%. Also, almost a dozen scholarly studies suggest that financial statement audits lower the cost of capital for public issuers by 25 to 70 basis points, or .25% to .70%.

Archival research about auditing is flourishing because archival data are available for large sample analysis of stock prices, audited accounting numbers, audit fees, and analysts' forecasts. But the studies are largely devoid of any knowledge of audit process.

In contrast to research *about* audits, since about 1990, research *in* auditing (or audit process research) such as new statistical applications, behavioral judgment issues, and audit input/output analysis has largely ceased to exist. For example, outside the Big Four firms, whether and how new statistical applications are built into complex audit software is largely unknown.

Audit input/output studies are rare today. We know that from 2003 to 2006, Big Four accounting and auditing services staffs increased by more than 44% while partners increased by less than 4% implying that most post-SOX growth has been at lower skilled positions. However, these data include accounting and private client services. No data on audit effectiveness, efficiency, or changes in public company audit inputs appears to be publicly available, although the PCAOB may evaluate such matters privately.

Behavioral research conducted largely before 2000 shows that auditors exhibit known and substantial behavioral biases when making audit judgments. These biases are strong enough to appear in a *laboratory setting* without real world pressures and without incentives to please others.

Behaviorally biased judgments will become critical as judgment-based accounting such as IFRS and fair value accounting are implemented. Audited results will increasingly reflect human judgment biases as well as expertise and incentives. Management also suffers from biases and will have superior knowledge and expertise and have incentives to act opportunistically. Auditors must then make judgments *about* judgments of management and standards setters must write standards for evaluating judgments and judgments about judgments! These are difficult tasks.

The audit process may be shifting from “given the rules, *is* management's number right?” to “given the principles, *could* management's number be right?” Now seems a bad time to have effectively precluded behavioral research *in* auditing – research that could help avoid negative consequences for the profession, investors, and the public at large.

The public needs to know if audited financial statements are reliable, if ICFR audit benefits are worth their cost, and if there are cheaper or more effective ways of doing

audits. The public also needs to have confidence in the oversight process. The PCAOB may know from its inspections whether standards have been followed, but are PCAOB Interim Standards adequate today? Independent research is needed to find out.

Simply put, today the audit process is largely treated as a “black box” both on and off campus. The “disconnect” harms all parties. First, it deprives *auditing students* of relevant audit education while at the university and it deprives promising *PhD students* of opportunities to succeed at top universities through meaningful scholarship in auditing.

Second, it deprives *practitioners* of access to conceptual knowledge freely available at universities that might facilitate new and innovative solutions to developing practice problems that are simply beyond the experiences of current practice leaders.

Third, it deprives *practitioners, investors, and the general public* of independent research that evaluates the effectiveness, efficiency, and value of large public company audits.

Time doesn’t allow consideration of the full array of possible remedies to the practitioner/professor disconnect, but I’ll comment on three posed in the Committee’s report.

First, I fully support sabbaticals for professors to participate in meaningful practice activities (Recommendation 3(b)). I’ve benefited greatly from a recent assignment as an academic fellow in the Professional Practice Group of OCA at the SEC. I increased my understanding of regulatory processes, participated in important policy and oversight matters, and was able to suggest policy alternatives. Furthermore, the knowledge and insights I gained were put to use this spring in my graduate auditing classes and in my research program on campus.

My assignment at the SEC was part-time and for only eight months due to my school’s shortage of auditing instructors. For many professors, flexibility as to timing and employment terms may be essential to designing effective practice sabbaticals.

Second, legislation encouraging access to data (Recommendation 3(c) last paragraph) may seem extreme, but there is a public as well as private need for data about public company auditors’ performance in fulfilling their statutorily mandated service.

Third, Professor Carcello’s idea of professional schools for public company auditing (Recommendation 5) deserves serious study. Frankly, public company auditing is not of broad interest within most business schools and neither auditing scholars nor auditing students are present at many schools today. Professional schools may be a vehicle to encourage and facilitate any necessary specialization at some universities.

I hope that these comments will be useful to the Committee and thanks for your attention.